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August 1984 $3

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DUN'S BUSINESS MONTH

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MANAGEMENT

The Spreading Wave Of Stock Buybacks

Low stock prices and cash hordes fuel buy-ins spree. But the benefits are mixed.

Don't they have anything better to do with their money?

For more than a year now, with machine-gun rapidity, one company after another has announced that it is going to buy back a big chunk of its own stock. The companies sport some of the biggest and best-known names in American industry: Coca-Cola, Time, K mart, Anheuser Busch, Exxon, Johnson&Johnson, Hilton Hotels, 3M, Weyerhaeuser, General Foods; they include big banks like Citicorp, U.S. Trust, Wells Fargo, Sun Banks; they even include lesser-known high-tech companies like Floating Point Systems, Prime Computer, NBI and Rolm.

Stock buy-ins, of course, are not a new phenomenon. Many companies have used them for years. In past market declines—in the summer of 1982, for one—there was a rash of repurchases. But the recent upsurge looks more like an epidemic. In the first six months of this year, Salomon Brothers calculates, 190 companies announced or completed buy-ins of 1 million shares or more. They spent $11 billion during that period and still had $8.6 billion more to go in uncompleted purchases. In contrast, last year's total was only $5 billion. Nearly fifty current programs are for more than $50 million worth of stock (*table, page 44*). And buy-ins of 5% or 10% of a company's outstanding shares are not uncommon.

What's behind the upsurge in buybacks? And are they good or bad?

Some are so-called greenmail, defensive maneuvers to ward off unwelcome corporate raiders. Such was the case in Texaco, Walt Disney and St. Regis. But these account for only a small fraction of the purchases.

The condition of the stock market is also an important factor. Buy-in programs took off last summer when the market receded from its all-time highs and many corporate managers decided that their stocks were undervalued and hence bargains. But since corporate executives usually feel that way, the question arises: Why now?

"They didn't always have the wherewithall to do anything about it," says Harvard Business School professor Paul Asquith. "Now, they do." The economic recovery produced a typical earnings rebound with an unusually large cash flow—an estimated $17 billion in additional cash from

faster depreciation alone last year. In addition, stricter inventory and receivable controls slashed working capital requirements, and companies in fast-growing industries, having sold stock or bonds when the market was hot, found themselves flush with cash.

Many Wall Streeters say that the popularity of buy-ins is a case of monkey see, monkey do. One notes that it's easy to sell repurchase programs by simply trotting out the names of others who are doing it. Then, he says, "They find the reasons." Finance professor James Walter of Wharton Business School agrees: "It's fashionable. Many companies have generated cash and not made plans for it, and at the same time the publicity of stock repurchases suggested that this was an attractive alternative."

In a probing study of repurchases by ten specialty chemical companies (out of sixteen publicly-traded companies), analyst Robert Hardiman of Merrill Lynch Capital Markets Group found a potpourri of motives, depending on the individual circumstances among the companies. He offers seven different reasons:

- For stock options.
- To stem falling stock prices.
- To mitigate effects of a cyclical decline in investment opportunities in the company's business.
- To reach management's return on equity goals.
- To get rid of excess cash in the face of slow sales growth combined with excess capacity.
- Possible plans to go private eventually; and
- Additional protection against an unfriendly takeover.

Companies that buy back their shares go about it in a number of ways. Some make a tender offer to all their shareholders for a specific number of shares usually at a premium over the market price. Others offer to buy holdings from their odd-lot shareowners at market price. Still others purchase privately shares from a single or limited number of stockholders (this is the method in greenmail). And there are those who buy shares on the open market in accordance with Securities and Exchange Commission buying limitation designed to avoid price manipulation.

Bookkeeping profits?

With so many diversely-situated companies using the same way to spend cash, the repurchase phenomenon has raised issues of corporate management and public policy. Critics ask:

- Are stockholders better off?
- Are managers using repurchases to reap quick bookkeeping profits?
- Why isn't the money being invested in business expansion?
- And are repurchases ratcheting up the already highly-leveraged state of American industry?

Many stockholders who care little about broad-ranging economic issues ask simply, "Is it good for the pocketbook?"

Conventional Wall Street wisdom says that stock repurchases don't pay off in higher prices, but academics have done studies that show otherwise. Theo Vermaelen, visiting professor at the University of Chicago, found that stock prices improved after repurchases, particularly if done through tender offers. He found that after adjusting for market fluctuations, stock prices gained 13% on average as a result of tender offers. (The average premium paid was 23% above market, and the average size of the purchase was 15% of the outstanding shares).

Tender offers pay off both for shareholders who sell and for those who don't. For example, this spring Rolm tendered for 3 million shares (11.5% of its outstanding shares) at $41 when its stock was trading at under 36 (for a 14% premium). Four months later, its price was above 39, despite an overall market decline. More dramatically, Teledyne offered $200 when its stock was trading at $155, and the stock subsequently rose above $230. "Both shareholders are winners," says Harvard's Asquith, "the ones who tendered and the ones who held on. I don't know who lost. I don't know what you can criticize."

The price advance appears to be contrary to efficient-market theory, since the intrinsic value of the company has not changed; it is merely smaller by the amount it returned to investors. But Vermaelen, a free-market exponent, argues that by making a tender offer, management informs its shareholders, with hard cash, that it

believes its stock is undervalued, and the market translates this signal into higher stock prices. He also says that the earnings performance of companies is spectacularly better in the five years following a tender offer-repurchase than in the five preceding years.

Open market buy-ins, with no premium or time deadline for repurchase, also lead to higher prices, but much smaller gains. On average, the stocks go up 3½% on announcement day, Vermaelen reports, but then settle down to a 2% gain, adjusted for market fluctuations. In the open market repurchases he studied, the stocks had underperformed the market by 7% in the three months preceding repurchase; thus, the repurchases successfully halted their deteriorating performance but did not bring them back to the market norm. The market interprets the buy-in as a signal that management considers the stock underpriced. But management is obviously not in a hurry to buy the shares nor offering a premium indicating that it doesn't see the stock as seriously undervalued. Therefore, says Vermaelen, the price rise is weak. Vermaelen didn't study the earnings performance of these companies.

A weak signal

Thus, Vermaelen supports Wall Street's low expectations of the effect of repurchases. Chief financial officer Terence A. Rixford of Floating Point Systems reports that before his company instituted its repurchase program, investment bankers told him to expect a blip in the stock upon announcement and then some fall-back. "I would say that as a result of the program we have seen an uplift in our stock price of maybe a dollar or so," he says, "but nothing significant." Floating Point's stock had plummeted twenty points to 14 and a fraction before the repurchase.

Since the overwhelming number of programs are open market repurchases, (Teledyne, Tandy, Cadillac Fairview and Rolm were the only tender offers during the first half of the year), it is little wonder that Wall Street and academia differ about the impact of repurchases. A 2% gain is significant academically, but it doesn't leave much in investors' pockets after commissions and taxes. When management repurchases shares for reasons other than a conviction that they are very cheap, Harvard's Asquith says, "then Wall Street is pretty much right. The impact is a wash."

Whatever the price gain, repurchases are certain to increase earnings per share. According to accounting rules, if the stock is bought for the corporate treasury there is a corresponding reduction in the number of shares outstanding used in computing

The Big Buy-Ins

Nearly fifty companies announced stock repurchase programs of at least $50 million during the first half. Total dollar value is determined by the price on the day of announcement multiplied by the number of shares involved.

	Shares (millions)	Dollars (millions)	% of Shares Outstanding
Exxon	46.3†	$1,900	5.9
Standard Oil	28.9	1,700	10.3
Texaco	25.6	1,280	9.9
Teledyne	5.0	1,000	25.0
Houston Natural Gas	8.0	555	20.0
Carter Hawley Hale	18.0	470	50.0
Tandy	10.0	355	9.6
Dart&Kraft	5.0	345	9.1
Minnesota Mining	4.3	339	3.7
Walt Disney	4.6	325	11.1
Coca-Cola	6.0	301	4.0
General Foods	5.3	275	10.0
Anheuser-Busch	4.8	267	10.0
Pacific Telesis	(1)	265	5.0
American Home Products	5.0	259	3.2
Penn Central	5.0	235	15.6
Santa Fe Southern	10.0	232	5.3
Avon Products	10.0	216	13.0
Rockwell International	(2)	200	(2)
Cadillac Fairview	15.0	189	18.0
American Medical Intl.	7.0	185	8.6
St. Regis	3.1	160	8.6
Levi Strauss	4.0	157	9.5
K mart	5.6	155	4.4
Atlantic Richfield	3.0*	135	1.0*
Weyerhaeuser	5.0	132	3.8
ROLM	3.0	123	11.5*
American Broadcasting	2.0	116	6.8
Rite Aid	6.0	115	14.2
Johnson & Johnson	3.0	114	1.5
Fluor	5.0	107	4.3
AT&T	6.1	100	0.1
Dresser Industries	4.0	90	5.1
Time	2.0	82	3.3
Amer. Hospital Supply	2.0	75	2.7
Dow Chemical	2.6	74	13.4
Castle & Cooke	3.4	71	11.8
Brown-Forman Distillers	3.1*	70	12.0*
Marriott	1.0	63	3.8
GEICO	1.1	63	5.0*
Textron	2.0	58	5.4
Wells Fargo	1.5	56	6.2
Holiday Inns	1.2	56	3.0
VF	2.0	55	6.1
Celanese	.7	54	4.8
Burroughs	1.0	52	2.2
Fuqua	2.0	51	23.0
Hilton Hotels	1.0	51	3.7
Medtronic	1.5	51	9.2

Notes: (1) Tender to odd-lot holders. (2) Open market purchases up to $200 million. † Company announced it repurchased 49 million shares. **Source:** Securities Data Corp., except (*) from company.

earnings per share. If the number of shares falls and net income is held constant, then each shareholder gets a bigger part of the income.

While repurchases typically make only a small contribution to earnings in terms of cents per share, that contribution to incremental growth can be substantial for slow-growth companies. Ralston Purina boosted its earnings 6 cents a share when it repurchased 5 million shares in the six months ended March 31, but that 6 cents accounted for 43% of its per share earnings gain for the quarter, according to security analyst Thornton O'glove of the *Quality of Earnings Report*. If all of Exxon's estimated gain of 26 cents a share from repurchasing 49 million shares falls into 1984, it could account for half of its expected earnings per share rise. And no matter how the 26 cents is distributed, "it's contribution will be dramatic," says analyst Barry Good of Morgan, Stanley & Co.

But the impact on the financial results is merely a bookkeeping ploy that should not fool analysts or investors in the long run. "The market should look through the pure accounting manipulation," says Vermaelen, "You cannot just create wealth by shoveling around pieces of paper." Even though earnings per share rise, net income doesn't climb as much.

It is merely a bookkeeping ploy that should not fool investors in the long run.

Is there a better use?

Because most repurchases don't increase financial results dramatically, the controversy over the practice focuses mainly on management's judgment in using the cash for this purpose and not another. Supporters argue that repurchases are preferable to holding cash and they take as a given the belief that management has weighed every possible use for the money and decided that there is no better buy currently than the company stock. Many security analysts, when queried about individual repurchase programs, agree.

But some Wall Streeters are frankly skeptical and they wonder why the company can't find better uses for these resources. They say that the buy-ins are a symptom of management's lack of imagination or courage to invest in their businesses. And they charge that management's unspoken motives are an effort to get a quick earnings-per-share shot in the arm, a hope and a prayer that their stock will rise, and a hope of warding off a takeover. "It's gutless," says market analyst Steven Leuthold of the Leuthold Group. "They ought to be investing in the company, building a brand-new automated plant or making some long-term commitments that may look dumb short-term but are the right thing to do in the long-term. What in hell's the sense of giving them all the tax advantages if they are not using them for the purposes for which they were legislated?"

Such criticism may be valid in some cases, but the variability of company circumstances makes it tough to generalize. Capital spending is robust and capacity appears to be adequate, notes James Balog of Drexel Burnham Lambert. "In the short-run, the ability to absorb new capital just isn't there. No amount of tax advantage is going to cause investment when it doesn't make sense." Using excess cash to diversify isn't always the answer, either. Many analysts note, for example, the failures of companies like Exxon that tried to expand into areas outside of their traditional businesses. "You might argue the return of that money to investors may be all to the good," argues Wharton's Heller. Furthermore, efficient-market theorists argue that returning capital to stockholders who then reinvest it redistributes the money to those firms that are willing and able to use it.

More worrisome are buybacks that appear to be harbingers of slowing growth. In his study of buybacks in the specialty chemicals industry, for example, Merrill Lynch's Hardiman found that many companies were experiencing slower sales growth, had cash-cow operations but a shortage of investment opportunities and feared to make acquisitions because of unhappy past experiences. He found the trend toward buy-ins a troubling indicator. "The longer-term implication may indicate a cash build-up problem and a lack of high-return investment opportunities," he observes. "It follows that future earnings growth rates could slow down, and a reduction of P/E multiples for some of these stocks may be warranted."

Although it is easy to say that companies are increasing their leverage—and thus their risk—by buying back stock because they automatically reduce the ratio of equity to debt, companies making repurchases, by and large, are not financially weak. They are generally mature, blue chip companies or banks that have good earnings performance and good capital bases. Even the young high-tech companies on the list have remarkably little debt.

Some analysts consider repurchases a partial liquidation of the company, based on a realistic assessment by management of its available options. "It's fair," says New York University accounting professor Lee Seidler. "It's telling the shareholders we have more money than we know how to invest in the company. Why should we be a mutual fund for you?" And as one analyst observes, it is certainly preferable to putting the money into a fancy new headquarters that earn no return.

Thus, the record suggests that there is no clear plus or minus about stock repurchases and the controversy will not be easily settled. But supporters and opponents agree on one point: the phenomenon is likely to continue. Wall Street sees no slowdown this year. Indeed, the utility industry is expected to join the parade because it is under pressure from reg-

ulators to pare its equity bases (as a way of holding down rates). New York's Consolidated Edison has already announced plans for a $250 million stock buyback in 1985. The investment bankers expect the trend to continue as long as the cash holds out. Unless, of course, the stock market takes off. Then, it is easy to predict that the wave of repurchases will recede even faster than it appeared.

—ARLENE HERSHMAN

Battle Over Business Judgment

Under the rule, courts have rarely challenged directors' decisions. But "greenmailer" buyouts could make it obsolete. Will Congress act?

To head off an unfriendly acquisition of their company by financial buccaneer Saul Steinberg in early June, the directors of Walt Disney Productions played their trump card. They bought back the 4.2 million Disney shares held by Steinberg's Reliance Holdings Inc. for an aggregate $325.3 million. That "greenmail" transaction gave Steinberg a net profit of some $32 million—and it also dropped Disney stock from $64 to $49 almost overnight. Irate shareholders promptly sued Disney and its directors, asking that the deal be cancelled.

There is little legal precedent to support such a suit. Historically, the courts have been extremely hesitant to challenge such decisions by a board. Under the "business judgment" rule, judges generally do not second-guess what directors have done as long as they appear to have acted in good faith.

Nevertheless, many lawyers and legislators argue that the tender offer craze has made the business judgment rule obsolete. It came into being a century or more ago, they say, as a means of keeping courts from interfering with the decisions of directors about the internal affairs of a corporation, where the board presumably had expertise and judges didn't. But critics insist that the rule should not apply to external affairs like takeovers, where the interests of directors and stockholders are often different, sometimes diametrically opposed. The dissidents call for either a tougher stand by the courts or for action by Congress to limit the discretion of directors in a battle for control of a company.

Tougher stand

Not surprisingly, most directors, and many lawyers, defend the status quo. The SEC's eighteen-member Advisory Committee on Tender Offers, for example, said last summer that "the business judgment rule should be the principal governor of decisions made by corporate management, including decisions that may alter the likelihood of a takeover." (The commission, however, did not agree with the views of the advisory group.)

Irving Shapiro, former chairman of E.I. du Pont de Nemours & Co., and now a lawyer in Wilmington, Delaware, staunchly defends the rule. So do Martin Lipton, the well-known takeover lawyer, and Ralph Ferrara, a former SEC general counsel. Ferrara admits that his views on business judgment have been considerably tempered since he entered private practice. "We don't need any tinkering with the process. Today, the outside directors are doing a superb job, and the courts are dealing effectively with any aberrations," he maintains.

Still, greenmail has been spreading like wildfire as more and more corporate raiders learn to play the game. Such high-powered market operators as Steinberg, Rupert Murdoch, Victor Posner and Carl Icahn, among others, have pocketed millions by being bought off. The practice dismays shareholders of many target companies, who feel that directors are simply paying ransom for the privilege of keeping their jobs and perquisites. The directors counter that they are acting in the company's best interests when they buy off a predator who, they argue, would do the shareholders no good in the long run.

This is an area where generalizations are uncommonly tricky. Observes former SEC general counsel Harvey Pitt: "There have been several recent cases where managements were flagrantly interested in entrenching themselves; there have been others where managements have made a bona fide judgment that selling out to a particular person was not in the best interest of stockholders." Every case, Pitt says, must be judged on its own merits.

Nevertheless, there is a big Congressional drive to stamp out greenmail—or at least make it tougher to obtain. In the Senate, Michigan Democrat Donald Riegle and Pennsylvania

More Evidence of Economic Strength

Executives are optimistic about sales and profits, according to a D&B survey.

The current economic expansion remains on an upward course, according to recent surveys by The Dun & Bradstreet Corp. For example, D&B's May survey of business expectations across the country shows that managers remain very optimistic about near-term prospects *(chart)*.

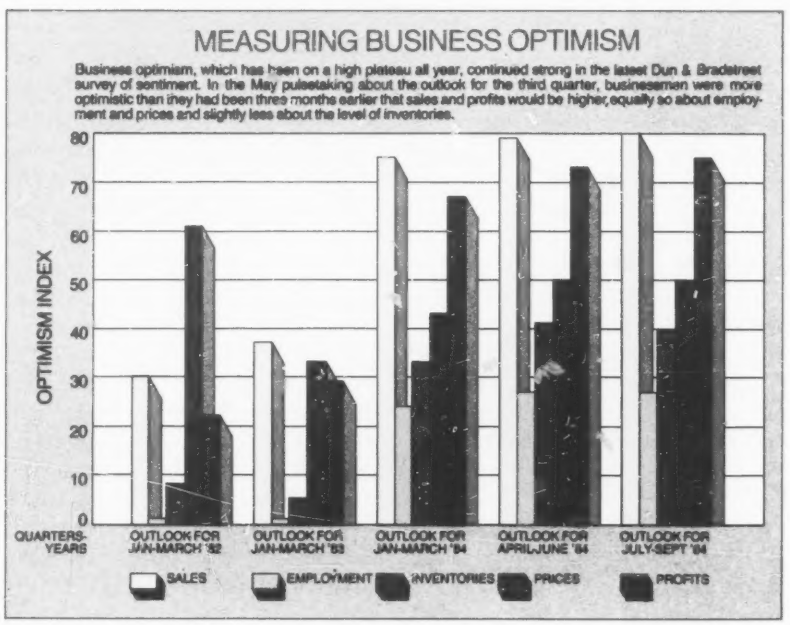
The overall optimism index remains at the very high level recorded in the first quarter of 1984. Companies plan to add inventory because they believe that recent sales gains will continue. Further, they expect profits to remain strong and only 50% expect their prices to increase in the next quarter. Thus, the current modest inflation should continue in the near term.

This strength in businessmen's outlook counters concerns that the expansion is running out of steam. While it is not unusual for executives to get caught up in the short-term results and ignore longer-term indicators, the results of this survey should not be discounted. Order books are strong (the survey shows that 81% of the respondents expect new orders to increase in the third quarter of 1984) and thus there is a good basis for the optimism expressed.

Additional evidence of economic strength is the D&B survey of building permit values in the nation's 200 largest cities. Recently released data show that the total value of building permits for 1984's first quarter is more than 27% over year-earlier levels. Since it takes several quarters before building permits translate into actual starts, these figures also show a basic strength in the current expansion.

Finally, D&B statistics on business failures are also upbeat. After reaching a plateau in the fourth quarter of 1983 and the first quarter of 1984, the D&B Business Failures Index in the second quarter shows a distinct decline. For the second quarter, the index is nearly 15% below the level of October 1983, showing that business failures are declining from the high levels that resulted from the last recession. Also, the liabilities involved in the reported failures are declining. At the beginning of 1984, 50% of failures had outstanding liabilities of over $100,000; at the end of June, only 48.5% of the failures had such liabilities.

On balance, all of these statistics from The Dun & Bradstreet Corp. describe a healthy economy with little evidence of excess. There is clear evidence that the expansion should continue at a steady pace in the months ahead. —JOSEPH W. DUNCAN


MEASURING BUSINESS OPTIMISM
Business optimism, which has been on a high plateau all year, continued strong in the latest Dun & Bradstreet survey of sentiment. In the May pulsetaking about the outlook for the third quarter, businessmen were more optimistic than they had been three months earlier that sales and profits would be higher, equally so about employment and prices and slightly less about the level of inventories.
OPTIMISM INDEX
80
70
60
50
40
30
20
10
0
QUARTERS-YEARS
OUTLOOK FOR JAN-MARCH '82
OUTLOOK FOR JAN-MARCH '83
OUTLOOK FOR JAN-MARCH '84
OUTLOOK FOR APRIL-JUNE '84
OUTLOOK FOR JULY-SEPT '84
SALES
EMPLOYMENT
INVENTORIES
PRICES
PROFITS

Joseph W. Duncan, formerly Chief Statistician of the Office of Management and Budget and Chairman of the United Nations Statistical Commission, is Corporate Economist of The Dun & Bradstreet Corp.

good franchise, Kiehne says. Long-term, he thinks they will grow on average at the rate of the Gross National Product, which he expects to be 8% (3% real growth plus 5% inflation), and the better managed banks will grow slightly faster. It is possible to find many banks selling at deep discounts to book ("our average bank holding is probably selling at two-thirds book," he says), in good areas, with good dividends, but their returns on equity are well below the industry average because of temporary problems—a sign to Kiehne that they have the improvability he seeks. "If we buy these banks, we naturally hope that they get bought out," he says. He has had four or five buyouts already. Among his current holdings he likes Maryland National Bank, National City Corp. of Cleveland, Society Corp. also of Cleveland, Moore Financial Group, Boise, Idaho and Meridian Bancorp, Reading, Pennsylvania.

When Kiehne worked at ATT, he supervised the installation of its first solid-state computer, and his interest in the field persists even though computer companies with low P/Es are hard to find. His big play is computer software company Applied Data Research, one of only three high-tech stocks in the fund. ADR makes systems software, which he considers a great long-term growth industry. The company's earnings per share last year were $1.37, which Kiehne expects to rise to $1.75 this year and to $2.20-to-$2.30 in 1985. Based on his expectations of 30% annual increases in earnings and revenues for many years from Applied Data's new software products, Kiehne compares the company to Cullinet Software, the industry leader, which has a 35 P/E, and he hopes that Applied Data could rise to a P/E of 20 from its current multiple of twelve. "It's the value side of high tech," he says.

At current prices, Kiehne also likes many department stores, which he sees benefitting from favorable demographics. His choices in the group are Allied Stores, Associated Dry Goods and Federated Department Stores.

—A.H.

INVESTMENT UPDATE

Here's the current status of a number of investments, and a look at how they have fared over the past month and the past year.

INVESTMENT	(6/29/84) Recent Price or Yield	Value of $10,000 if invested: Month Earlier	Year Earlier
Common Stock (Index fund, capital gains and dividends reinvested)	$18.40/share	$10,220	$ 9,514
per cent change		+2.2%	−4.9%
Bonds (30-yr., 11¾% Treasury Bond)			
MARKET VALUE		$ 9,920	$ 8,247
ACCUMULATED INCOME	$ 85.62	$ 113	$ 1,131
TOTAL		$10,033	$ 9,378
per cent change		+3.3%	−6.0%
Money Market Fund	9.92%	$10,081	$10,931
per cent change		+.8%	+9.3%
Gold (Krugerrands)	$436.50/oz.	$10,476	$11,064
per cent change		+4.7%	+10.6%
HOUSE PRICES	Recent	Month Earlier	Year Earlier
Existing House	$81,700	$84,400	$77,900
per cent change		−3.2%	+4.8%
New House	$90,600	$93,900	$93,000
per cent change		−3.5%	−2.5%

Sources: Vanguard Group Inc.; Salomon Brothers; Donoghue's Money Fund Report; Deak-Perera Fifth Avenue, Inc.; Federal Home Loan Bank Board.

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